

Emerging Manager Program

Ted Eliopoulos
Real Estate

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Introduction

- CalPERS Real Estate Unit (REU) has had extensive experience investing with Emerging Managers (EM) including many with diverse ownership, however, the REU has not had a formal EM program.
- A formal EM program, directing new investment capital to successful and promising new talent, is consistent with CalPERS philosophy on diversity and inclusion in the marketplace.
- The objectives of an EM program are to: 1) achieve appropriate risk adjusted returns, 2) access investment opportunities that may not otherwise be pursued, and 3) increase diversity among our pool of investment managers.

Recommendation

- Staff recommends approving the initial phase of a formal EM program. The initial phase proposes the following two prong approach:
 1. Develop a program structure with the following investment parameters:
 - EM program will be in the Domestic Tactical portfolio
 - Up to \$200 million of new capital
 - California focus: EMs and underlying assets will be located in California
 - Staff will select existing real estate investment managers with proven track records and certain competencies to select, oversee, and mentor EMs
 - EM Definition – Investment managers with less than \$1 billion AUM and limited to 1st, 2nd, or 3rd commingled fund and/or separate account investment strategy
 2. Establish a process to track the workforce diversity of existing investment manager firms.

Recommendation

- The EM program parameters include:
 - 5-year term
 - Modest co-invest from EMs
 - 50% leverage limit at the asset and fund level
 - Opportunistic risk classification consisting of multiple property types
 - The relationship structure between the existing investment manager and EMs has yet to be determined
- Staff will report a program update annually to the Investment Committee
- Staff will return to the Investment Committee after 5 years to assess the program and consider, at that time, a second phase

Development of EM Program

- Staff retained a consultant, Crosswater Realty Advisors, to assist in research, design, and program development. Key findings include:
 - EMs are typically “under the radar”, making sourcing EMs a time intensive and complex effort
 - Mentoring is critical
 - EM definitions vary widely across institutional investors and the universe of qualified EMs is small – approximately 20-50 firms
 - While EM fund of fund managers exist, many are emerging themselves
 - MWBEs are more likely to be EMs
- Recommendations
 - Definition of EM: Investment managers with less than \$1 billion AUM and raising their 1st, 2nd, or 3rd commingled fund and/or separate account investment strategy
 - Two pronged approach: Mentoring program structure and tracking workforce diversity in existing investment management firms
- Staff concurs with Crosswater’s recommendations

Real Estate Unit's Emerging Manager Experience

- Below are: 1) current and prior EM investments with domestic opportunistic strategies, 2) capital allocations, and 3) investment strategies. **Managers with diverse ownership are in bold:**
 - \$100.0M - American Value Partners – Emerging Manager Fund of Funds
 - **\$100.0M - AGI-TMG Housing Partners – Housing**
 - **\$175.0M - Bridge Housing –Affordable multifamily**
 - **\$ 50.2M - CMR – Structured debt**
 - \$ 75.0M - Divco West – Office
 - **\$ 50.0M - Integral Urban – Various urban**
 - \$ 60.5M - Klein Financial – Affordable housing
 - **\$ 75.0M - Meruelo Maddux – Housing and mixed use**
 - \$100.0M - Pagemill Properties – Housing
 - \$ 60.0M - Phoenix Realty – Various urban
 - \$ 75.0M - Savannah – Office
 - \$ 50.0M - Strategic Partners – Various property types
 - \$100.0M - Towers on Capitol Mall – Mixed use
 - \$ 50.0M - The Procaccanti Group (TPG) - Hospitality
 - **\$100.0M - Urban America – Various urban**
 - **\$100.0M - Valencia Capital – Medical office and housing**
 - \$1.321B – Total Allocation

Real Estate Unit's Emerging Manager Experience

- Below are managers that met the EM definition at the time CalPERS first allocated capital to them. These managers have since transitioned to large investment relationships.

Managers with diverse ownership are in bold:

CORE

\$ 443M - CIM Urban REIT
 \$3,745M - Commonwealth Partners – Office
 \$2,148M - GID – Multifamily
\$2,080M - Miller Capital – Retail
 \$ 8.42B - Total Allocation

HOUSING

\$1,350M - Hearthstone
 \$1,000M - Institutional Housing Partners
\$1,360M - MacFarlane Weyerhaeuser
 \$1,498M - Newland Capital Advisors
 \$ 815M - Resmark Equity Partner
\$1,674M - Shea Homes
 \$ 7.70B - Total Allocation

OPPORTUNISTIC

\$ 562M - Buchanan Street Partners –Various
\$ 220M - Centerline – Multifamily
 \$1,230M - CIM – Various property types (ex-REIT)
\$ 625M - CityView - Housing
 \$1,000M - GI Partners – Private equity
\$1,200M - MacFarlane Partners (CUIP) – Various urban
 \$ 242M - Premier Pacific Vineyards – Vineyards
\$ 300M - RLJ – Hospitality, structured debt
\$ 177M - Stockbridge – Mixed use and housing
 \$ 5.56B - Total Allocation

INTERNATIONAL

\$ 500M - Aetos Capital
\$ 500M - ARA
 \$ 564M - Secured Capital
\$ 218M - Xander
 \$ 1.78B – Total Allocation

Emerging Manager Performance as of December 31, 2010

- While some EMs had positive performance, overall the CalPERS Real Estate EMs have not met investment expectations and have under-performed relevant benchmarks

	AFTER FEE		
	1-Year	3-Year	5-Year
Existing and Prior Emerging Managers (pg. 6)	-6.1%	-34.4%	-22.1%
Diverse Existing and Prior Emerging Managers (subset of above, pg. 6)	-38.1%	-25.8%	-14.6%
Emerging Managers that Transitioned to Large Separate Accounts (pg. 7)	-4.4%	-29.1%	-16.8%
Opportunistic Real Estate Portfolio (ex-pages 6 and 7)	-1.3%	-21.9%	-8.9%
COMPARISON PERFORMANCE RESULTS			
Townsend Opportunistic Benchmark (after fee)	22.0%	-18.7%	-2.4%
NCREIF Property Index + 200bps (Private component of the REU benchmark, BF)	15.1%	-2.2%	5.5%

Lessons Learned

- What was done in the past was not successful. A focused, formal EM program with dedicated staff and/or consultant services is required to mitigate risk and capitalize on the opportunities of an EM investment strategy.
- Program structure and mentoring is very important, however it is time and resource intensive.
- Strong, clear, and focused governance rights are key to successful outcomes.
- EMs with developer track records may have a tough transition to fund management and need back office/reporting support.
- EMs ability to withstand market downturns is more difficult due to their small size and lack of experience.
- Discipline and focus on strategy, especially during peak market cycles, is important to EM success.
- EM firms may be under capitalized, which may impact the manager's ability to operate the company while sourcing investors and investments.
- Downstream JV agreements, at the asset level, must be successfully negotiated to protect the best interests of the fund.

Conclusion

- Staff recommends approving the two pronged initial phase of a formal EM investment program.
- Staff will report annually a program update to the Investment Committee.
- Staff will return to the Investment Committee after 5 years to assess the program and consider, at that time, a second phase.